Institute of Actuaries of India

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Liyaquat Khan
President

November, 30th 2010

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: July 30, 2010 Exposure Draft "Insurance Contracts"

Dear Sir David,

We thank you for the opportunity to given to comment on the Exposure Draft – Insurance Contracts and strongly support the objective of the ED to develop a high quality standard addressing the recognition, measurement, presentation and disclosure requirements for insurance contracts. We welcome many aspects of the Exposure Draft (ED), in particular the use of fulfilment value model based on the risk adjusted expected values. We also support the reflection of entity specific characteristics of the liability, including liquidity, in the discount rate and the need for an explicit risk adjustment. The measurement of insurance contracts utilizing a 'whole contract' approach which encompasses contract boundary criteria and inclusion of expected cash flows associated with participating contracts is also welcomed.

There are a few areas where we have a different view. These are explained in our response to the questions in the attached note.

Please do not hesitate to contact me (president@actuariesindia.org) should you need any further clarifications on our comments.

Note: In the response IAI stands for the Institute of actuaries of India.

Yours truly,

Liyaquat Khan

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Question 1 – Relevant information for users (paragraphs BC13–BC50)

Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

IAI Comments: We support the model proposed in the ED.

Whilst many aspects of an insurer's activities are similar to other businesses, there are several other aspects that make the overall nature of insurance business unique and therefore warrants a separate accounting standard. We therefore support the decision to exclude insurance contracts from the scope of other standards.

Question 2 – Fulfillment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51)

(a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?

IAI Comments: Yes, we consider this principle to reflect economic value of the cash flows related to an insurance contract.

(b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

IAI Comments:
The level of guidance is appropriate for a principles based standard. We would however seek further clarity on the definition of current estimates for insurance companies that do not have enough years of experience. In such young or start-up companies, the use of current estimates would not be appropriate. One particular example we can give is that of expenses.

Further, we believe that paragraphs B45-47 place undue emphasis on the use of replicating portfolio techniques. The requirement to demonstrate that there is no material difference between the technique employed and a replicating portfolio technique is an onerous one. Whilst the technique is indeed a sound technique in certain circumstances, the use of the same in an insurance portfolio is some times limited.

In the area of expenses (B62 and B63), we believe that all relevant expenses relating to a portfolio of insurance contracts should be included in the fulfillment cash flows. We believe that cash flows should include both overhead expenses and expenses which are directly assignable to individual policies. Not to do so would understate the policyholder liability and overstate the residual margin. We therefore seek a review of these aspects of B62 and B63.

Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104)

(a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

IAI Comments:
We agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the liability rather than those of the assets backing that liability as this is in accordance with a realistic reporting approach.

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While we appreciate the ED is a principles based document we do believe given the sensitivity of liability values to the interest rates chosen, the Board may wish to give more guidance on the construction of risk-free yield curve (e.g. swaps, government bond yields, corporate bonds) which could be used in more advanced markets and also emerging markets. Furthermore, particularly given that in many markets insurance contracts extend well beyond the horizon of the yield curve extrapolation of the yield curve is a critical issue significantly impacting the value of insurance liabilities. Explicit guidance from the Board in this area would be most welcome.

(b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?

IAI Comments:
We agree with the inclusion of a liquidity premium in the discount rate. We believe it best to provide the principle, as in paragraph 30, and provide minimal guidance on its implementation.

(c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

IAI Comments:
We do not recommend inclusion of non-performance (i.e. own credit risk) by the insurer. We believe that inclusion of own credit standing into liability valuation would result in an accounting profit in the event of a downgrade to an insurer and this would be misleading. We recommend addressing this through additional information to investors and analysts.

Question 4 – Risk adjustment versus composite margin (paragraphs BC105–BC115)

Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

IAI Comments: We prefer the risk/residual margin approach as these two items conceptually represent different matters.

Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123)

(a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?

IAI Comments:
Yes, we agree, although rather than defining it as “maximum amount payable”, we would recommend defining it as “an amount that would provide a high degree of certainty that the insurer would be able to fulfil the contract”. We believe an explicit risk adjustment is an important component in presenting an economic valuation of the insurance contract liability. The proposed approach represents the amount an insurer would pay to be relieved of the risk rather than the market price that would be charged.

(b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?

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IAI Comments:
Whilst the three approaches are comprehensive, we do not believe the proposals should be restricted to three as this is not consistent with a principles based standard. This would prevent inclusion of improved actuarial techniques as these are developed. Further some techniques have limited applicability (example – CTE is best used for portfolios with fat tails).

(c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?

IAI Comments:
We do not agree with the suggested approach as this need not provide useful information to the users unless all assumptions are disclosed along with relevance of the method used. In fact, this may be misleading as it would not provide a consistent comparison between companies. Furthermore, requiring disclosure of results under any single particular approach will encourage entities to choose that approach so as to limit the amount of work involved even where it is not the most appropriate one to be used. We believe the disclosures should be around the techniques employed and sensitivity analysis.

(d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (i.e. a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?

IAI Comments:
We disagree with the Board's approach and submit that the risk adjustment be permitted across all insurance contracts given the significant diversification effects that exist between product lines. The current approach to our mind overstates the risk adjustment for well diversified insurers.

(e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

IAI Comments:
We prefer technical guidance be provided through actuarial associations that have core expertise in this area. The Board could keep the measurement guidance at principles level.

Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133)

(a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?

IAI Comments:
There are different views on whether to allow an initial gain or not. Given the definition of the cash flows to be included in the measurement of the liability we tend to support the concept of a residual margin and go along with the principle that an insurer should not recognize any gain at initial recognition of an insurance contract. We would prefer this to be done at the level of cohort of contracts and not at the level of individual contract.

If of course gains were to be allowed at issue in line with economic principles then the cash flows to be included in the measurement of the liability should include non-incremental acquisition expenses as well as general overheads as we have stated above so as to avoid an overstatement of profit at inception.

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(b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?

IAI Comments:
We believe that recognizing a loss at inception is appropriate to reflect the economic substance of the contract.

(c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?

IAI Comment:
We agree, but would seek further clarity on 'similar date of inception' and 'similar coverage period' so that 'similar' is not construed as 'same'.

(d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?

IAI Comments:
We do not believe the suggested approach will always provide reasonable results as there is a disproportionate emphasis on the pattern of incurred claims and benefits. An alternate approach could be to let the insurer choose the method on the basis of a selected profit driver at a product level (similar to the Margin of Services method in Australia).

(e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?

IAI Comments:
We prefer calculation of explicit risk adjustment and residual margin.

(f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

IAI Comments:
We believe that interest should be accreted on both the residual and composite margins as these margins essentially represent differences between discounted amounts at inception and therefore should be adjusted for interest.

Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140)

(a) Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

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IAI Comments:
We welcome the inclusion of incremental acquisition costs in the contract cash flows. However, we are concerned about the definition of acquisition costs as incremental at contract level. We believe acquisition costs should be accounted for in terms of being incremental at the portfolio level. Further, we believe the definition of incremental acquisition costs will have to be re-worded. The proposed wording of 'would not have been incurred if the insurer had not issued that particular contract' could potentially exclude incremental costs associated with contracts that the insurer attempted to issue but could not or did not issue.

Question 8 – Premium allocation approach (paragraphs 54-60 and BC145–BC148)

(a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?

IAI Comments:
We support a single measurement model for all insurance. However, we recommend that simplified approaches should be allowed for relatively straightforward contracts to avoid detailed building block determination. We therefore support view (ii) (i.e. permit, but not require).

(b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

IAI Comments:
On the basis that the premium allocation approach is a simplified approach operating as a proxy for the full model, we would recommend that it should be available for use as required and no criteria for use are necessary. Therefore, the guidance should allow for judgment in selecting the appropriate model.

Question 9 – Contract boundary principle (paragraphs 26-29 and BC53–BC66)

Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

IAI Comments:
We agree with the suggested approach as if the insurer is unable to re-price the contract to fully reflect the risk of a particular policyholder there is indeed an ongoing obligation in terms of the original contract.

Question 10 – Participating features (paragraphs 23, 62-66, BC67-BC75 and BC198–BC203)

(a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?

IAI Comments:
We agree with this approach and this is in line with the approach of fulfillment value.

(b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?

IAI Comments:
We believe that financial instruments with DPF should be within the scope of the IFRS on insurance contracts as it reflects the fact that such contracts are economically similar.

(c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?

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We do not support the condition that the definition is met only where there are also insurance contracts that participate in the same pool of assets or the profit or loss of the same company, fund or entity.

(d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?

IAI Comments: We agree with the modifications.

Question 11 – Definition and scope (paragraphs 2-7, B2-B33 and BC188–BC209)

(a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarized in paragraph BC191? If not, why not?

IAI Comments:
We agree that in the assessment of significance of risk the present value of additional benefits paid should be used as opposed to simply the nominal value as this seems to us the natural way to place a value on payments to be made in the future.

We see no reason to consider whether the present value of net cash outflows can exceed the present value of premiums in any scenario. Assessment of significance of risk should not, to our mind, be influenced by the probability of loss to the insurer. Even contracts where the insurer is certain to always make a profit could still be insurance contracts.

(b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?

IAI Comments:
We believe that once it has been established that a contract meets the principles it would be appropriate to measure it within the insurance contracts proposals. For example, we see no reason to exclude fixed fee service contracts that would qualify as insurance contracts.

(c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

IAI Comments: Yes – we believe the insurance standard is the best fit for these contract features.

Question 12 – Unbundling (paragraphs 8-12 and BC210–BC225)

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

IAI Comments:
We do not agree with the requirement to unbundle as it does not add any great benefit to any one, including users of financial statements. We believe that a contract should be recognized in its entirety instead of being viewed in components. If the IASB insists on unbundling, we suggest that the phrase ‘closely related’ should be clarified sufficiently.

Question 13 – Presentation (paragraphs 69-78 and BC150–BC183)

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(a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?

IAI Comments:
We believe that the Board's proposed presentation will be very useful to users of financial statements as information about experience variances and changes in both prospective financial and demographic assumptions are disclosed.
We suggest the Board can also mandate that the various items are split into new business and inforce components so users will be able to see the profitability of the new business sold during the period.

(b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

IAI Comments:
We agree that all income and expenses should be shown in the profit and loss account with adequate description of various components so users can effectively judge the performance of the entity.

Question 14 – Disclosures (paragraphs 79-97, BC242 and BC243)

(a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?

IAI Comments: We agree with the principle as presented as this is consistent with IFRS 7.

(b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?

IAI Comments:
We believe that the proposed disclosure requirements will meet the proposed objective to help users of financial statements.

(c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

IAI Comments: We do not have any comments.

Question 15 – Unit-linked contracts (paragraphs 8(a)(i), 71 and 78, Appendix C and paragraphs BC153–BC155 and BC184-BC187)

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

IAI Comments:
We support the proposals to require fair value measurement. However, single line treatment in comprehensive income overlooks important elements of profit and loss. We believe it would be appropriate to widen this within the scope of IFRS 9 as well as IFRS 4 to provide consistency and comparability within the financial statements.

Question 16 – Reinsurance(paragraphs 43-46 and BC230–BC241)

(a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?

IAI Comments:
We support this as it is consistent with the measurement model for the underlying insurance contract liabilities.

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(b) Do you have any other comments on the reinsurance proposals?

IAI Comments:
The ED allows the cedant to recognize a gain at inception of the reinsurance contract. We find this inconsistent with the requirement that an insurer should eliminate all gains on inception. Further, the ED does not specify what happens if a gain on a ceded reinsurance treaty is more than the loss on the underlying insurance contract to the insurer.

Question 17 – Transition and effective date(paragraphs 98-102 and BC244–BC257)

(a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?

IAI Comments:
The proposals would result in a significant drop in post-transition earnings from existing books of particularly long term business. This because the proposal to set the residual margin to zero upon transition will reduce liability, whilst equity is increased, and make the reported profit to appear much smaller than before.

(b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?

IAI Comments: We do not agree with composite margin, as stated in our response to question 4.

(c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?

IAI Comments: Yes, for reasons of avoiding implementation complexities.

(d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.

IAI Comments: We do not have any comments.

Question 18 – Other comments

Do you have any other comments on the proposals in the exposure draft?

IAI – None.

Question 19 – Benefits and costs (paragraphs BC258 – BC 263)

Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.

IAI Comments:
We believe that the ED, when issued with suitable amendments, will meet the objective of consistent and comparable financial statements of insurers. We believe that the benefits will eventually outweigh the costs.

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